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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

November 5, 1992

Ms. Donna R. Searcy
Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, D.C. 20554

RE: Ex Parte Meeting
<u>CC Docket No. 92-101</u>

Dear Ms. Searcy,

On November 5, 1992, Jeff Olsen and R.T Gregg, representing the United States Telephone Association (USTA), met with Cheryl Tritt, Kathy Levitz, Michael Mandigo and Greg Vogt of the Common Carrier Bureau regarding the above-referenced proceeding.

The discussion centered on the attached written material. Reference was made to two earlier ex parte meetings held on September 9, 1992 and October 16, 1992.

The original and a copy of this ex parte notice is being filed in the Office of the Secretary on November 5, 1992 and should be included in the public record.

Respectfully submitted,

Linda L. Kent

Linda L. Kent
Associate General Counsel

Attachment

cc: Cheryl Tritt
Kathy Levitz
Michael Mandigo
Greg Vogt

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List A B C D E

CC Docket No. 92-101
Exogenous Cost Treatment of Incremental SFAS 106 Costs
USTA Ex Parte

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What is SFAS 106?

- Statement of Financial Accounting Standards No. 106[1] (SFAS 106) is the statement adopted by the Financial Accounting Standards Board (FASB) regarding accounting for Other Postretirement Employee Benefits (OPEBs). FASB-adopted statements represent changes in Generally Accepted Accounting Practices (GAAP).
  - GAAP is the set of accounting rules and guidelines companies must follow when publicly reporting earnings and financial positions.
  - The Commission's Part 32 Accounting Rules require regulated telecommunications carriers to maintain their financial records in accordance with GAAP.
- OPEBs are benefits <u>other than pensions</u> paid on behalf of <u>retirees</u>. These benefits are primarily medical care, but also include dental care and life insurance.
- SFAS 106 moves from a <u>cash basis</u> to an <u>accrual basis</u> for recording the costs associated with postretirement benefits earned by employees.
- SFAS 106 requires that companies record the cost of these benefits <u>as they are earned</u> by employees, rather than waiting to reflect these costs after employees retire and benefits are received by retirees.
  - Thus, SFAS 106 properly matches the cost of providing OPEBs with when they are earned.

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[1] Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, issued December 1990.

Description of SFAS 106 Accounting

Example of a single individual (based on typical characteristics):

- **Hired in 1974.**

- **Expected to be "vested" for OPEBs in 2000 at 50 years old with 25 years service.**

- **Expected to retire in 2010 with 36 years service.**

- **Expected to die in 2028 at age 78.**

	Benefits Accrue			Benefits Paid	
Year	**1974**	**1993**	**2000**	**2011**	**2028**
Age of Employee	24	43	50	61	78
Length of Service	0	18	25	36	--

TBO (1974–1993)

Attribution Period (1974–2000)

Total Expected Length of Service (1974–2011)

- **Benefits are accrued as earned by employee from the year 1974 through 2000 (the attribution period). Benefits are paid from the year 2011 through 2028.**

- **The TBO, Transition Benefit Obligation, is the portion of total SFAS 106 costs associated with benefits already earned at the point in time when SFAS 106 accounting is adopted, 1993 in this example. [The TBO is approximately half (18 years divided by 36 years) of the present value of expected benefits.]**

SFAS 106 expenses are a real cost of doing business.

- Accrual accounting is consistent with fundamental ratemaking theory which is premised on the fact that costs and benefits accrue to the generation of customers responsible for the costs or benefits.

- SFAS 106 recognizes that an employee earns OPEBs over the employee's service life and that the company should recognize its costs of providing OPEBs during the same period.

- Effective 1-1-93, SFAS 106 will be the generally accepted accounting standard for OPEBs, will be reflected in LECs' Part 32 accounting and should be reflected in price cap indexes.

    - In its December 26, 1991 order, the FCC adopted GAAP accounting for OPEBs for all carriers. Thus, SFAS 106 costs are legitimate regulated costs of service, recognized in Part 32 of the Commission's Rules.

    - Rate of return carriers are presently being allowed rate recovery of the incremental costs of SFAS 106 (for example, in CC Docket No. 92-141 and NECA tariff filings).

    - It is a pure accident of timing that accrual accounting for OPEBs was mandated after price cap regulation. Price caps were debated for 4 years; accrual accounting for OPEBs was debated for over 12 years.

- During the debate over price cap regulation, both LECs and the Commission recognized that the long-pending accrual accounting for OPEBs was a primary (possibly the most significant) example of the need for the exogenous cost adjustment mechanism within the price cap framework.

The mandate to implement SFAS 106 is the exogenous event.

- Price cap LECs should be allowed to increase price cap indexes to reflect that the initial price cap rates did not adequately include the true economic costs of OPEBs.

- However, the exogenous test must be met.

  - These costs are outside the control of the LEC, and;

  - The costs are not already recovered due to operation of the price cap formulas (i.e., not reflected in the GNP-PI inflation measure).

    - AT&T accepts that exogenous cost treatment is appropriate, but suggests flawed revisions to the LEC actuarial valuations that would reduce the exogenous amounts.]

The incremental costs of SFAS 106 are outside the control of LECs.

- The price cap LECs do not control the mandate to implement SFAS 106 on their financial or regulated books. Both the FASB and the FCC require SFAS 106 accounting.

- For a given group of employees and retirees and given benefit plans, the incremental costs of SFAS 106 are known (determined by actuarial study).

  - LEC actuarial valuations have numerous interrelated calculations that cannot be arbitrarily changed without rendering the subsequently modified SFAS 106 valuation invalid.]

Only a minuscule portion of added costs are reflected in the GNP-PI.

- Both the Godwins study and the NERA study clearly reveal that only a minuscule portion of the incremental LEC costs caused by SFAS 106 are reflected in the GNP-PI.
  - Both studies were reviewed by the California Commission.
  - The proposed California order concludes that both studies produced similar credible results and states that the Godwins study is very conservative.
- The Godwins study was extremely conservative in nature. Conservative in this sense means that all assumptions in the Godwins study were chosen so that it overestimates the extent that SFAS 106 costs are captured in the GNP-PI.
- The NERA approach, though different, is very tractable and reasonable. It yields similar results -- that the incremental costs of SFAS 106 are not recovered through changes in the GNP-PI.
- Thus, based on the reductions to the exogenous amounts requested by the price cap LECs, there is no double counting of SFAS 106 costs occurring from exogenous cost treatment requested and price cap formula, which includes GNP-PI .

The LEC SFAS 106 costs are reasonable.

- SFAS 106 costs are calculated in compliance with the FASB rules and are based on sound, well-accepted actuarial principles.

- These costs are subject to the scrutiny of independent auditors (the SFAS 106 costs are auditable), and the SEC and shareholders/investors (through disclosures and financial reports). SFAS 87 regarding pension expense requires a similar methodology.

- SFAS 106, like SFAS 87, requires each company to reflect company-specific information in its valuation. Because of differences in company demographics, benefit plans and experience, a simplified set of standard assumptions is not appropriate.

Consistent with incentives to be more efficient.

- The price cap LECs do not look to exogenous treatment for SFAS 106 as a replacement for cost containment.

- Exogenous treatment is not an opportunity for windfall profits. Quite the contrary, if exogenous treatment is denied, earnings will be significantly reduced.

- The price cap LECs are simply requesting an opportunity to recover legitimate costs of doing business.

The price cap LECs and USTA have responded to <u>all</u> oppositions raised in the 4 (really only 3 distinct) filings:

AT&T
MCI
Ad Hoc Users Group and ICA filings (attach the same ETI study)